Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DEN:POSTF-152031-01
WRDavis

date: 11/26/01

to: Team Coordinator, [redacted] Audit Team, Englewood, CO
Attn: Revenue Agent Sharon Christianson

from: Area Counsel
(Natural Resources:Houston)

---

subject: [redacted]
Section 1031 Exchange

On November 6, 2001, this office forwarded to your attention a copy of a memorandum providing our proposed response to the above-referenced request, along with a cover memorandum explaining that the proposed response was subject to a 10-day post review period. In accordance with the recommendations of the National Office, we are herein supplementing our discussion of the litigation hazards connected with your proposed position.

To that end, this writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

Other Considerations

(b)(7)a [redacted].

(b)(7)a [redacted]

(b)(7)a [redacted].[1]

(b)(7)a [redacted].

Please feel free to contact the undersigned if you have any questions on this matter at(303) 844-2214, ext. 259.

BERNARD B. NELSON
Area Counsel
(Natural Resources:Houston)

By: /s/
WILLIAM R. DAVIS, JR.
Attorney (LMSB)

---

[1] The Tax Court went on to distinguish this "desire" from an "intent" to exchange the property for like-kind property; the Ninth Circuit found this distinction to be one without a difference. Alderson, 317 F.2d at 793.

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DEN:POSTF-152031-01
WRDavis

date: 11/6/01

to: Team Coordinator, [redacted] Audit Team, Englewood, CO
Attn: Revenue Agent Sharon Christianson

from: Area Counsel
(Natural Resources:Houston)

subject: [redacted]:
Section 1031 Exchange

We write to provide you with our comments to the draft copy of the protest to the Service's adjustment consolidating the tax treatment of the exchange of [redacted] assets as a single like-kind exchange of several exchange groups, as contrasted with the taxpayer's treatment of this as two transactions - a like-kind exchange and a separate sale. Our recitation of the facts and review/analysis of the contentions of the taxpayer follows.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

Facts

The taxpayer, [redacted][1], entered into an agreement to transfer certain [redacted] equipment and distribution plant to [redacted] or "the Purchaser"), on [redacted][2] ("the Agreement"). The

---

[1] Since the date of the transaction, [redacted], has been involved in [redacted] corporate reorganizations. This opinion does not address the successor party with respect to which these adjustments now pertain.

[2] The draft protest to the Service's position regarding the treatment of the entire transaction as a like-kind exchange, subject to I.R.C. § 1031 for all assets exchanged, indicates that assets were exchanged in both [redacted] and [redacted]
(continued...)

Agreement required the transaction to close not later than [redacted] years from the date of the Agreement, or by [redacted]. On [redacted], prior to the actual closing date, the taxpayer entered into a separate exchange agreement with a party designated as, and qualifying as, a "qualified intermediary" ("QI") in accordance with Treas. Reg. § 1.1031(k)-1(g)(4)(iii), and established a "qualified trust," as defined in Treas. Reg. § 1.1031(k)-1(g)(3)(iii).

The transaction closed on [redacted]. By and through the trust, the QI agreed to acquire interests in the old property, hold sales proceeds, acquire interests in new property and exchange the new property for the old property. The new property was timely identified under the requirements of I.R.C. § 1031(a)(3)(A), and that the new property was received by the taxpayer within 180 days, in accordance with section 1031(a)(3)(B).

On its return, the taxpayer reported the transfer of some of the assets under the Agreement as constituting a like-kind exchange, and treated the remaining assets transferred under the Agreement as a cash sale. In the draft protest, the taxpayer asserts that it has the flexibility to determine which transferred assets to include (and not to include) in its like-kind exchanges, and that it is free to allocate consideration received "for simultaneously effected transfers" in the manner that minimizes its tax liabilities[3].

The sale price for the assets acquired by [redacted] was $[redacted], adjusted from $[redacted]. The [redacted] assignment to the QI was a "partial assignment" of the taxpayer's rights under the Agreement with [redacted], allegedly identifying only those assets which the taxpayer desired to transfer as part of a like-kind exchange, and assigning only the right to receive $[redacted], that portion of the total consideration to be paid by [redacted] allocated to the identified exchange assets, to the QI. The taxpayer further asserts that, with respect to those assets not identified as exchange assets, it elected to treat the

[2](...continued) apparently under separate "Sales Contracts." It is not clear whether the dates of transfer were the same in each transaction. In any event, nothing in the facts that are outlined in the Service's write-up of this issue, or the taxpayer's protest, indicate that the Service's position, or the taxpayer's response do not equally apply to each "Sales Contract."

[3] Draft Protest, at 9.

transfer to [redacted] as a separate and distinct cash sale outside the scope of its exchange transaction with the QI and the qualified trust. According to the draft protest, the taxpayer directed [redacted] to transfer $[redacted] the sale proceeds from the non-exchange assets, directly to the taxpayer. The taxpayer recognized $[redacted] of this amount as taxable gain on the sale of trade or business assets. To our knowledge, the Agreement did not contain any provision that would have permitted the taxpayer to sell only those assets identified as exchange assets to [redacted] without selling the non-exchange assets, or to sell only the non-exchange assets to [redacted] without the exchange assets. In other words, the Agreement was one integrated transaction.

Of the $[redacted] in proceeds directed to the QI, $[redacted] was not spent on like-kind replacement property, and was eventually transferred to the taxpayer. On its return, the taxpayer reported its recognized gain as $[redacted] and deferred gain of $[redacted] by treating all but $[redacted] of the gain realized on the transfer of the so-called exchange assets as deferred. The gain realized with the transfer of the other assets was treated as a separate asset sale, and recognized on the taxpayer's return. The taxpayer allocated the proceeds of the high-basis property that it relinquished to the Purchaser, [redacted] to the "sale," and the proceeds from the relinquished low-basis property to the like-kind exchange. By bifurcating the Agreement into (1) a like-kind exchange of its low-basis property and (2) a sale of its high-basis property is proper, the taxpayer will defer an additional $[redacted] in gain than if the exchange of property and receipt of cash is all treated as a single like-kind exchange with boot.

Analysis

The taxpayer contends that nothing precludes it from determining which transferred assets it includes or excludes from a like-kind exchange. In so arguing, it contends that it is permitted to allocate consideration received from its qualified intermediary in the form of like-kind property to the like-kind exchange, and to allocate the consideration received directly from the Purchaser of the taxpayer's assets to a separate sale. The taxpayer correctly notes that Treas. Reg. § 1.1031(j)-1 provides no authority for the definition of what constitutes an "exchange." Likewise, however, the regulation does not provide for segregation of the properties transferred and received under one exchange into two separate transactions for tax purposes - a like-kind exchange of lower-basis properties, and a sale of higher-basis properties.

The taxpayer cites Letter Ruling 9627014 to support its view of the latitude that the law gives to a taxpayer to define a single exchange. By allocating the receipt of cash proceeds to the "sale" of higher-basis assets falling within the same exchange group as other lower-basis assets that the taxpayer treated as part of the like-kind exchange, the taxpayer reduces the amount of gain that it would otherwise recognize under the like-kind exchange regulations. The notice of proposed adjustment quantifies this amount at approximately $[redacted]. The resolution of this dispute appears to turn on the scope of the term, "the exchange."

Finally, the taxpayer cites to case law to support its right to allocate cash receipts - i.e., the boot in the exchange - in the manner it chooses. Specifically, it cites to the cases of Sayre v. United States, 163 F. Supp. 495 (D. W. Va. 1958), and Serdar v. Commissioner, T.C. Memo. 1986-504, as supporting the fragmentation of the Agreement.

Initially, we present the findings of our research concerning the scope of the term, "exchange." Next, we opine as to the applicability of the authority cited by the taxpayer in its memorandum. Finally, we assess potential hazards of these positions.

What Constitutes an "Exchange"?

Our investigation finds support for the Service's proposed treatment of the transaction described in the Agreement as one exchange. To start with, Treas. Reg. § 1.1031(a)-1(a)(2) provides the applicability of section 1031 to exchanges of property not solely for property of a like kind. Recognizing that such transactions do not fit within section 1031(a), which concerns exchange of property held for productive use in a trade or business or for investment solely for property of a like kind which is to be held for productive use, the regulation nonetheless points out that the transfer will be within the provisions of section 1031(b), dealing with gain from exchanges not solely in kind[4], or section 1031(c), dealing with loss from

---

[4] I.R.C. § 1031(b) states:

> If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, (continued...)

exchanges not solely in kind. In any event, from both the Code provision and the regulation, it is clear that the application of section 1031 is mandatory, not elective. See, e.g., United States v. Vardine, 305 F.2d 60, 66 (2d Cir. 1962); Godine v. Commissioner, T.C. Memo. 1977-393; National Outdoor Advertising Bureau, Inc. v. Commissioner, 32 B.T.A. 1025, 1035 (1935).

In the case of Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968), the court considered a taxpayer trucking firm's structuring of its acquisition of new trucks from, and sale of used trucks to the same manufacturer as two separate transactions. The court rejected the taxpayer's contention that it had avoided the application of section 1031, which would have allowed the taxpayer to realize gains and losses on the transactions. The court focused on the substance of the transaction, and found that "[t]he buying and selling were synchronous parts meshed into the same transaction and not independent transactions." Id., 399 F.2d at 656.

Beyond pointing out that "the intention to avoid or minimize taxes, beneficent as it is, cannot be employed where the end product is a mere subterfuge," the court stated that "an integrated transaction may not be separated into its components for the purposes of taxation by either the Internal Revenue Service or the taxpayer." Id., 399 F.2d at 658; accord, Biggs v. Commissioner, 632 F.2d 1171, 1177-1178 (5th Cir. 1980). In contrast to Redwing Carriers, the taxpayer here wishes to ignore the fact that it transferred all of the [redacted] plant to [redacted] through the same Agreement. To that extent, the taxpayer here seeks to ignore that fact, and give more weight to the structure that it later applies to the receipt of like-kind proceeds and cash proceeds.

We further note that, as contrasted with cases such as Bell Lines, Inc. v. United States, 480 F.2d 710 (4th Cir. 1973), where the Service unsuccessfully argued that the transaction to purchase certain trucks was mutually dependent on a separate transaction to sell other trucks, the instant case involves one transaction to sell [redacted] assets. Prior to closing the sale, the taxpayer arranges its consideration to constitute, in part, other [redacted] assets, and in part, cash. Disregard of the actual form of the transaction is not generally permitted.

---

[4](...continued)
then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

In Greene v. Commissioner, T.C. Memo. 1991-403, the Tax Court discussed the binding nature of the form of a transaction on a taxpayer, and the significance of the transaction's form with respect to the application of section 1031:

> The substance over form doctrine applies where the form chosen by the parties is a fiction that fails to reflect the economic realities of the situation. . . . However, as Mr. Greene had the freedom to cast the transaction in any manner which he saw fit, he should not be free to cast it aside when he determined, after the fact, that the original form did not meet his needs. "If the exchange requirement is to have any significance at all, the perhaps formalistic difference between the two transactions [sale or exchange] must, at least on occasion, engender different results." In other words, the form of a transaction cannot be ignored in this analysis.

Id., T.C. Memo. 1991-403 (citations omitted).

Likewise, in the instant case, the taxpayer cannot now ignore the form of transaction. It transferred all of its [redacted] property in one exchange, as is reflected in the Agreement. For tax purposes, the taxpayer impermissibly recasts this transaction into two transactions - one a like-kind exchange of some of its [redacted] assets for other [redacted] assets, and the other, the sale of [redacted] assets that fall within the same exchange groups as those it "exchanged" for the majority of the "boot" received in the transaction. It must, instead, apply Treas. Reg. § 1.1031(j)-1 to the proceeds received pursuant to the Agreement, and recognize gain as determined under this scheme.

Authority for Taxpayer's Position

The authority cited by the taxpayer does not support its position. We first examine Letter Ruling 9627014. As the draft protest points out, the taxpayer that was the subject of that ruling desired to exchange a portion of its automotive fleet rather than continue the sale/purchase process it had theretofore used. However, in contrast to the taxpayer's assertion, the taxpayer proposed the Master Vehicle Exchange Agreement with a Qualified Intermediary to effect the exchange of vehicles. The ruling does not indicate that the structure was used so that the taxpayer could "sell certain vehicles not designated for exchange and receive the proceeds directly from the manufacturer and thereby effect a sale." Nor was this agreement described as necessary to the continued sale of vehicles to the manufacturers, as the draft protest asserts.

Once the actual steps involved in that letter ruling are examined, that transaction is clearly distinguishable from the instant taxpayer's exchange of [redacted] assets. Most important, under the letter ruling, the taxpayer transferring the property committed to identifying the assets relinquished in the like-kind exchange **simultaneously with, or in advance of**, its transfer of them to the QI, pursuant to the exchange agreement. This identification of relinquished assets set forth the scope of those assets relinquished in the exchange. No prior agreement to transfer specific property was superceded or otherwise modified. Other assets not covered by the exchange agreement were separately transferred to the purchaser. In contrast, the taxpayer here first agreed to transfer all [redacted] assets to be acquired by [redacted] in the Agreement, not in a bifurcated or manifold transaction.

We note, with interest, the phrasing that the taxpayer used in the draft protest here in describing its directions to [redacted] (the Buyer) concerning the portion of the purchase price to transfer to the QI. Despite the taxpayer's "partial assignment" of its rights under its Sales Contract with [redacted] pursuant to the "Old Property Assignment," for which the taxpayer obtained [redacted]'s consent in the form of a "Transferee's Consent," it seems unusual that the taxpayer still had to provide direction to [redacted] regarding the amount of purchase proceeds that the "exchange assets" represented. To the extent that time permits, you may wish to examine the "Old Property Assignment" to see whether, and the extent to which, it identified those properties that it purports were the "exchange assets" if you have not already done so.

Next, we look at the taxpayer's reliance on Sayre v. United States, 163 F. Supp. 495 (D. W. Va. 1958), as authority for its allocation of cash consideration to certain assets. That case concerned an individual's transfer of (a) property held for productive use, specifically farm property, and (b) his home - admittedly property not qualifying for like-kind treatment under the predecessor to section 1031 - for similar farm property to be held for productive use, and cash. Id.

The government there contended that both the cash and the farm property received should have been apportioned as proceeds attributable to both the farm property and the residence relinquished by the taxpayer. The court rejected this scheme, and adopted the one urged by the taxpayer. That apportionment method took into account that the taxpayer had spent at least $9,000 of the cash - the fair market value of the relinquished residence - on a new residence within the replacement period. Applying the predecessor to repealed section 1034, which had allowed for rollover of the gain on the sale of a taxpayer's principal residence, the court opined that the taxpayer's only real economic gain was from the amount by which the cash received exceeded the disposed-of house's fair market value. Id., 163 F. Supp. at 497-498.

More important, the court treated this as a single transaction - in contrast to the position taken by the instant taxpayer. The court rejected the government's proposed pro-rata apportionment of each of the properties received to each of the disposed-of properties, a scheme far different than the one required under Treas. Reg. § 1.1031(j)-1. In rejecting the government's proposed pro-rata apportionment, the court did point to the absence of any regulations directing the manner in which the non-like-kind proceeds had to be apportioned. However, since that time, regulations have been promulgated that direct taxpayers on how, in multiple property transfers such as this one, to apportion the property received to the property relinquished. Instead of following the scheme laid out in Treas. Reg. § 1.1031(j)-1, the taxpayer here proposes to fragment the exchange - for which (we understand) the relinquished assets were identified in one document - into two transactions, solely to reduce the amount of gain it has to recognize with respect to the cash that it received in the transaction. In contrast to the factual circumstances in Sayre, the taxpayer here does not have an equitable argument supporting its position. Moreover, it chooses to ignore the direction of the regulations on how to apportion received property to determine gain. Rather, it purports - for tax savings reasons - to be entitled to treat a single transaction as two transactions.

Finally, the taxpayer's reliance on the holding in Serdar v. Commissioner is curious. Additionally, it appears that the taxpayer misreads the facts of Serdar. There, the court was primarily concerned with whether the consideration the taxpayers received for contiguous properties included, as a component thereof, a prepayment penalty. To the extent that it did not, the second issue was whether the sale of one property of the taxpayer qualified for installment sale treatment, and whether the exchange of another property of the taxpayer qualified for nonrecognition treatment under section 1031.

First, we note that the taxpayer claims that Serdar involved the separate treatment of two property sales to the same buyer on the same day "even though the sale of each property was conditioned on the sale of the other property."[5] In actuality, as the draft protest otherwise acknowledges, the contracts for the sale of the two parcels were negotiated at separate times. While the court acknowledged that the value to the purchaser of owning both parcels was greater than their individual value, and that the purchaser considered them to be essential to his plans, the facts, as recited in that opinion, do not show that the sale of either property by Serdar to the purchaser was conditioned on the sale of the other property. Id., T.C. Memo. 1986-504.

Next, careful reading of the opinion discloses that, while the Service argued for the installment sale and exchange to be treated as one transaction, this position was directed at the issue of whether the consideration received by the taxpayer in the year of sale prevented it from qualifying for installment sale treatment. The Service did not similarly argue this point in disputing the taxpayer's ability to defer gain recognition from a like-kind exchange. Rather, the Service objected on the ground that the exchanged properties as were not being held either for productive use in a trade or business or for investment, a requirement for a like-kind exchange under section 1031.

The court refused to consider this contention because it found that the Service had not properly raised this as an issue in the pleadings, and found it unfair where the taxpayers had not known in advance of the need to present evidence concerning the use of the properties in question. Id., T.C. Memo. 1986-504. Thus, any citation to the court's holding in Serdar is, at best, dicta.

Other Considerations

(b)(7)a [redacted].

(b)(7)a [redacted]

---

5 Draft Protest, at 12.

(b)(7)a (b)(7)a [redacted].

Please advise us if the facts as we have recited them differ materially from your understanding of the facts. If you have further questions, please call the undersigned at (303) 844-2214, ext. 259.

BERNARD B. NELSON
Area Counsel
(Natural Resources:Houston)

By: /s/

WILLIAM R. DAVIS, JR.
Attorney (LMSB)